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Uniform Law Commissioners
The National Conference of Commissioners on Uniform State Laws

SUMMARY

Revised Uniform Limited Liability Company Act (2006)

The **Uniform Limited Liability Company Act** gestated from 1994 to 1996 when it was finally promulgated by the Uniform Law Commission. By that time the majority of the states had legislation that provided for limited liability companies. Therefore, the 1996 Uniform Act has been enacted in only nine states by 2006. The limited liability company as a distinct form of business organization has a very recent history. The first legislation in Wyoming in 1977 introduced the concept. A limited liability company is generally characterized as a business organization which looks like a partnership or limited partnership in terms of internal structure and relationships between members, or members and managers, but with the additional characteristic of a liability shield from vicarious liability for members and managers.

A limited liability company has members who primarily contribute capital to the company and who share in the profits or losses. It may have managers who do the business of the company. A member may be a manager, but non-member managers are also allowed. If there are no designated managers, members run the company as general partners in a general partnership would. A limited liability company statute has certain key features: a means of creating the company, usually by filing a certificate; a liability shield provision; rules governing the relations between members, and between members and any managers; rules governing distributions of profits or losses to members and a member's creditor's rights; rules governing a member's exit rights from the company; rules on dissolution of the company, and rules governing mergers and conversions. A limited liability company is usually governed by an operating agreement that almost always supercedes and overcomes the statutory rules.

The limited liability company originated in the desire to have a full liability shield while retaining the so-called "pass-through" qualities of a partnership. This means that the company itself pays no federal income tax, leaving any tax liability to members receiving taxable distributions from the company. Before limited liability companies, full limitation of liability was available only for corporation shareholders. Corporations, however, are taxed as individuals on their income, but shareholders are also taxed on corporate distributions made to them. The ability to obtain pass-through status, then, provided very substantial incentive for states to enact limited liability company statutes. They did this, but did not do so with anything like coherent uniformity. The great wave of statutes preceded the promulgation of the 1996 Uniform Act.

Limited liability companies have other qualities than pass-through status that make them desirable as a business organization. A limited liability company may be tailored specifically to the business or objective of the members because its structure mainly depends upon the agreement between members and managers (if there are managers). This means a kind of flexibility coupled with the liability shield that makes the limited liability company a more efficient kind of organization than the corporation (specifically) or any of the other unincorporated business organizations for many purposes. The limited liability company kind of structure lends itself to nonprofit organizations, and many states (and the successive Uniform Acts) do not require a for-profit reason for organization. The limited liability company form has been adapted to allow a single member company to be formed. A single person may not form a partnership or limited partnership. Forming a corporation raises the tax issue and the complexities of maintaining a corporation for a single shareholder. A single-member limited liability company resolves these problems, and makes it an efficient way for a single individual to have a vicarious liability shield.

Because of its utility, the law of limited liability companies is very dynamic. New ideas and features seem to appear yearly with the objective of enhancing this form of business organization. The many developments since 1996 have led the Uniform Law Commission to reconsider the Uniform Act. The result is the 2006 Uniform Limited Liability Company Act.

The issues addressed in the 2006 Uniform Act are issues of formation, relationships between members and managers (if applicable), distributions, disassociation, dissolution and winding up, foreign limited liability companies, merger and conversion and actions against a company by members. It is not possible in a short summary to do more than highlight some significant changes. Here are some of the changes made in 2006 over 1996:

1. In the 2006 Act, the operating agreement determines whether a company is manager-managed or member-managed. In the 1996 Act the kind of management is determined in the certificate of organization. If the agreement is silent, the company is a member-managed company by default. Leaving this decision to the agreement allows the company to determine and re-determine its management structure more flexibly. A third-party creditor may seek affirmation of a manager's or a member's authority before doing business with the company and practice indicates does so without checking the official record for the certificate. In addition, certificates of authority may be filed to provide notice that only certain members or managers in a company are entitled to do business on behalf of the company.

2. There is no requirement that a company's operating agreement be in writing in either the 1996 or 2006 Act. However, the definitions "record" and "signature" establish that any statute of frauds requirement within the 2006 Act may be satisfied with electronic records and signatures. The 1996 Act does not recognize electronic records or signatures.

3. A member may not transfer his or her membership in a company, unless the operating agreement makes it possible. The only interest that may be transferred is called the "distributional interest" in the 1996 Act and the "transferable interest" in the 2006 Act. In the 2006 Act, a "transferable interest" is generally any right to distributions that a member has under the operating agreement. The operating agreement may impose restrictions on a right to transfer. However, the certificate of organization may provide that a "transferable interest" is freely transferable under the 2006 Act. If it does, the transferable interest may be certificated in the same manner any investment security is, and is likely to be a security under Article 8 of the Uniform Commercial Code.

4. In both the 1996 and the 2006 Acts, members owe a duty of care to each other. The duty in the 1996 Act is to refrain from conduct that is grossly negligent or reckless conduct, intentional misconduct or knowing violation of law. In the 2006 Act, the standard is ordinary care (care that a person in a like position would reasonably exercise) subject to the business judgment rule.

5. Under both the 1996 and 2006 Acts, the operating agreement governs the relationships between members and members and managers (if any). The 1996 Act, however, provides that the duty of loyalty and the duty of care may not be eliminated in the operating agreement. But the operating agreement may specify those acts and transactions that do not violate the duty of loyalty, so long as not manifestly unreasonable. In the 2006 Act, the operating agreement may eliminate the duty of loyalty or duty of care, provided that eliminating them is not "manifestly unreasonable." The agreement may not authorize intentional misconduct or knowing violations of law, as well.

6. The 1996 Act does not expressly address the issue of indemnification of members or managers, but the 2006 Act does. It provides for indemnification as a statutory matter. But the operating agreement may alter the right to indemnification, and may limit damages to the company and members for any breach except for breach of the duty of loyalty or for a financial benefit received to which the member or manager is not entitled.

7. The 1996 Act makes no provision for companies that are initially organized without members. There must be at least one member upon filing the certificate of organization. In the 2006 Act, a member does not necessarily need to be named at least 90 days from the day the certificate is filed. There is a limited ability, therefore, to create what are called "shelf" companies.

8. One issue that especially vexes limited liability company law is the rights creditors of members have in the assets of the company. The 1996 Act restricts creditors' interests to a member's distributional interest and provides a judgment creditor with a "charging order" as the only method of executing against that interest. The resultant lien may be foreclosed and sold in a judicial foreclosure sale. The 2006 Act further requires a finding: that payment may not be made within a reasonable time, before a court orders foreclosure of the lien. This finding is not required in the 1996 Act. In addition, the 2006 Act makes it absolutely clear that a purchase in a foreclosure sale does not make the purchaser a member.

9. In the 1996 Act dissociation (resigning from membership) of a member by express will triggers an obligation to buy the interest of that member in an at-will or term company. Failure to buy may subject the company to a judicial dissolution and winding up of the business. The 2006 Act provides no obligation to buy out a dissociating member, nor a ground based upon failure of a buyout for judicial dissolution. The company has greater stability under the 2006 Act, notwithstanding any dissociation of a member.

10. The 1996 Act provides members with the right to file a derivative action on behalf of a company alleging certain kinds of misfeasance on the part of the company by its management. Under the 2006 Act, the company may form a "litigation committee" to investigate claims asserted in a derivative action. This stays the litigation while the committee does its investigation. The objective of the investigation is to determine if the litigation is for the good of the company. The litigation committee ultimately reports to the court with a recommendation to continue with the plaintiff or the committee as plaintiff, or to settle, or to dismiss.

11. The 1996 Act allows no right of direct action against the company on behalf of a member as a plaintiff. The 2006 Act provides for direct action.

These are some of the changes in the **2006 Uniform Limited Liability Company Act**. It is not possible to do more than highlight some of the more prominent changes. Hopefully, this summary will alert readers to the improvements sufficiently to interest them to support the 2006 Act in the state legislatures.

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